Commission should eliminate exogenous treatment for cost changes caused by the completion of the amortizations of inside wire and the depreciation reserve deficiencies. The Transitional Support Fund obligations also have terminated, and the Commission should also delete this reference from the rules.

Further, MCI urges the Commission to delete from its list, tax and "other" exogenous changes that the Commission has the discretion to allow. MCI believes it should eliminate the tax exception because industry-specific taxes already are represented in the GNP-PI.[73] Even if the Commission concludes otherwise, however, the tax changes that have been granted under this provision have been minimal and do not warrant the administrative burden necessary to recognize them.[74] MCI recommends deletion of the "other" category because it is unnecessary. The Commission always has within its power the ability to declare costs exogenous, provided that its decision is consistent with existing policy. Moreover, the Commission always can waive its rules based on a showing of special or unique circumstances.[75] Retention of the "other" category serves only to

[73] Any industry-specific taxes on industries other than telecommunications would be reflected by those industries and their prices and would, thus, affect the GNP-PI.

[74] NYNEX, which has had one of the largest such adjustments, made approximately a 0.3% adjustment to its price caps due to the New York State gross receipts tax.

[75] Northeast Cellular Telephone Co. v. FCC. 897 F.2d 1164, 1168 (D.C. Cir. 1990), citing WAIT Radio v. FCC, 418 F.2d 1153, 1157, 1159 (D.C. Cir. 1969) cert denied, 409 U.S. 1027 (1972) (applicant must demonstrate rule is unjust in its unique situation). The Common Carrier Bureau recently restated the waiver test as follows: "[w]hether [petitioners] have shown such special circumstances as individualized hardship or inequity that warrant deviation from the Commission's

encourage the LECs to continuously test whether they can find new exogenous costs to squeeze through this potential loophole. Thus, elimination of the "other" category will minimize both this temptation and the ensuing administrative burden.

Further, MCI urges the Commission to reiterate its conviction that depreciation expenses should not be accorded exogenous treatment. The Commission initially excluded depreciation from its list of approved exogenous charges because it correctly recognized that LECs control the underlying investment decisions that ultimately determine actual depreciation expenses. Significantly, in subsequent proceedings focusing on LEC depreciation practices, the Commission has reconfirmed its original decision. First, while examining depreciation simplification, the Commission reiterated that "[d]epreciation costs and rates are directly affected by a carrier's plant deployment and retirement decisions, and thus are not considered exogenous."[76] Next, the Commission denied exogenous treatment to United Telephone for state-mandated infrastructure investment, noting that "[i]f the Commission were to guarantee recovery of depreciation expense for carriers, it would risk destroying the very incentives that the price cap program was designed to create."[77] As the LECs become involved in a growing number of new services, they likely will be making more and riskier

... rules and whether such deviation better serves the public interest." Petitions for Waiver of Transport Rate Structure and Pricing Requirements, 9 FCC Rcd 796, 800 (Com. Car. Bur. 1994).

[76] Simplification of the Depreciation Prescription Process, CC Docket No. 92-296, Report and Order, 8 FCC Rcd 8025, 8031 (1993).

[77] United Depreciation Order, 9 FCC Rcd at 391.

investments, the primary focus of which may not be basic telephone operations. Reiteration of its policy not to grant exogenous treatment to depreciation expenses will confirm the Commission's basic belief that the underlying decisions that drive depreciation rates result from business strategies for which the LECs must be willing to face the financial consequences.

Baseline Issue 6b: Which cost changes should be eligible for exogenous treatment under price caps.

MCI argues that there should be unambiguous limitations to the costs that are accorded exogenous treatment, and it urges the Commission to revise the list of costs qualifying for exogenous treatment to include only specific, Commission-ordered cost changes that shift costs between the interstate and intrastate jurisdictions or between regulated and non-regulated operations.[78] For any cost not on the list, exogenous treatment would be available only through grant of a waiver petition. This criterion is unambiguous and simple to administer, thereby eliminating potential disputes and the accompanying consumption of scarce administrative resources. By adopting this proposal, the Commission would avoid a protracted battle each time it released an order that might impose costs on carriers. Viewed from a different perspective, the risk of regulation appropriately would fall on the LECs' shareholders, not their ratepayers. It is with the sharehold-

[78] MCI is concerned that the Commission's proposed "economic cost" criterion is difficult to define in a practical way that will limit exogenous costs. That is, varied interpretations of what this standard means likely would result in disparate conclusions about what categories of costs should be considered exogenous.

ers of price cap carriers that this most basic business risk belongs, since it is they who reap the first rewards if the company is successful.

Indeed, the only reason for including jurisdictional cost changes in the plan is the legal and policy necessity for creating a mechanism that recognizes jurisdictional cost changes. Without the limited list of exogenous costs recommended by MCI, decisions to shift revenues into or out of the interstate revenue requirement could not be implemented.

Those exogenous changes that MCI did not recommend deleting in Baseline Issue 6a, supra, meet MCI's proposed standard. Clearly, reallocation of investment between regulated and non-regulated activities and changes to the Separation Manual fall into this category. This standard would limit exogenous treatment of changes in the USOA to those that result in the reassignment of costs between jurisdictions or between operations. Appropriately, it would not allow carriers to take exogenous treatment for accounting changes that affect industries throughout the economy.[79]

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[79] For example, as MCI opined in its opposition to the 1993 annual access tariffs the Commission should require endogenous treatment for the costs associated with implementing the Statement of Financial Accounting Standards No. 106 ("SFAS-106") (MCI Petition, at 2). SFAS-106 requires all companies to convert to an accrual method from a cash-basis method of accounting and reporting Other Postretirement Employee Benefits ("OPEB"). Under the new method, companies must make adjustments to their financial statements to reflect the accrued cost of postretirement benefits "earned" by their current work force in any given year. Although the Commission authorized all subject carriers to implement SFAS-106 on or before January 1, 1993, it currently is investigating whether exogenous treatment of the associated costs should be allowed for ratemaking purposes. MCI contends that the Commission should refrain from granting SFAS-106 costs exogenous treatment because it does not meet the standard MCI recommends the

Had this standard been in place, exogenous treatment would not have been extended to regulatory fees and costs associated with the Telecommunications Relay System.[80] In addition, no costs shift into or out of the interstate revenue requirement because the Commission is imposing fees. In fact, considerations of fairness require the Commission to specifically exclude future fee charges from exogenous treatment. Other segments of the telecommunications sector pay fees, and they have no mechanism for automatically passing them through to their customers. Because all companies face similar fee costs, and because the imposition of fees does not have an impact on interstate revenue requirements, the Commission should not include them in its modified list of exogenous changes.

MCI's suggested exogenous treatment of the costs associated with divested properties, however, comports with the proposed standard.[81] The selling carriers' price cap indexes must be adjusted both to recognize their reductions in interstate plant and to remove the greater assignment to interstate costs due to increased subsidies the acquiring carrier frequently will realize.[82] The Commission should also allow exogenous treatment of the expiration of equal access expense

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Commission adopt for allowing exogenous treatment of costs.

[80] Under this standard, the Commission would not have allowed exogenous treatment of any 800 database costs.

[81] See Baseline Issue 10, infra.

[82] If a property were acquired by a small independent LEC, it likely would receive a larger USF payment and a the benefit of "triple-DEM weighting," a mechanism the Commission adopted to increase the interstate allocation of switching investment to encourage small LECs to modernize their plant. 47 C.F.R. § 36.125(f) (1992).

amortizations. Such treatment complies with MCI's proposed standard for exogenous treatment because it recognizes the removal of these amortized expenses from the LECs' interstate costs. It also is consistent with the previous exogenous treatment of the inside wire and reserve deficiency amortizations.

Adoption of exogenous treatment for equal access amortization should not signal LECs that the Commission will permit such treatment for any amortizations that commence after initiation of price cap regulation. The Commission authorized a downward adjustment in rates associated with the inside wire and reserve deficiency amortizations when they were completed because otherwise "it would be unfair to ratepayers who [were then] bearing the cost of the amortization program[s]."[63] As a rule, amortization represents a change in the timing of expenses, not a change in their level. The LECs' expense levels at the initiation of price caps were inflated by the inclusion of an unnaturally high level of expense resulting from the amortizations already in progress, and they must be reduced to reflect their expiration.

In sum, the Commission should adopt MCI's proposed new standard for exogenous cost treatment. It is simple to administer, unambiguous, and properly places the risk of regulation where it belongs -- on the shareholders. By clarifying that exogenous treatment should apply in only those cases where LEC costs have shifted (either into or out of the interstate revenue requirement), the Commission

[63] LEC Price Cap Order, 5 FCC Rcd at 6808.

will ensure that interstate rates continue to reflect costs assigned to the interstate jurisdiction by regulatory action.

<u>Baseline Issue 6c</u>: Whether the Commission should adopt an administrative process to allow access customers or other groups to request cost changes eligible for exogenous treatment and, if so, what should be the procedures in such an administrative process.

Under the current price cap system, the LECs have no incentive to reveal those cost changes that would reduce -- rather than increase -- their price cap indexes. Any time costs deemed exogenous increase, the LECs can pass them on to ratepayers by recalculating their price caps. If the LECs do not reflect all exogenous cost reductions in their price cap indexes, however, they would in effect be credited (in the form of reduced or forestalled sharing) for productivity gains over which they have no control.

MCI believes that adoption of its proposal to revise the exogenous cost theory and limit exogenous costs to a pre-approved list would obviate the need for additional administrative procedures to ensure ratepayers reap all benefits they are due. If MCI's proposal is not adopted, however, MCI alternatively recommends that the Commission adopt a formal process for reflecting declining exogenous costs in the carriers' price cap index. Specifically, the Commission should initiate a petition procedure for interested parties to request inclusion of those decreasing exogenous costs that the LECs might not otherwise be inclined to seek. The petitions should be solicited in advance of the LECs' annual access filings, in time for a decision on whether the requested items will be included.

BASELINE ISSUE 7: SERVICE QUALITY, INFRASTRUCTURE MONITORING, AND NETWORK RELIABILITY

Baseline Issue 7a: Whether the Commission should increase or revise the monitoring of the LECs' network reliability, service quality, and infrastructure development.

In recognition of the possibility that the profit motivation underlying price caps would provide incentive for LECs to delay or eliminate network investment or maintenance, the Commission expanded the service quality and infrastructure development monitoring requirements for price cap LECs.[84] Yet, as the Commission notes, service quality under price caps has been comparable to the levels achieved under rate of return regulation.[85]

MCI believes the current monitoring requirements for LECs have proven effective in two respects, and should therefore be retained. First, the very existence of the reporting requirements encourages the maintenance of at least the same or higher LEC operating performance. The knowledge that they must file specific reports encourages the LECs to improve operations. Second, the reports appear to be effective in identifying potential service problems and alerting the industry. For example, the Commission recognizes "the possibility of some problem"[86] in the residential service area. Also, the infrastructure development reports have raised the issue that "telephone penetration rates are substantially

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[84] LEC Price Cap Order, 5 FCC Rcd at 6827.

[85] Notice, at para. 27.

[86] Id.

lower in certain insular areas."[67] By identifying inconsistent performance, the reports direct the industry's attention to areas that require increased maintenance or attention.

The existing monitoring procedure has proven to be successful both in mitigating potential service quality problems and in flagging them should they nonetheless arise. If these reports identify a serious decline in service quality, however, MCI then would urge the Commission to consider strengthening the requirements. Otherwise, MCI recommends no changes to the procedures at this time.

Baseline Issue 7b: Whether and if so how the Commission should expand its service quality monitoring to include price cap LEC facilities and services that may be interconnected with the local exchange network or used to provide similar capabilities, including wireless services and coaxial cable.

The Commission should maintain systematic service quality monitoring so long as the LECs retain monopoly control over the bottleneck component of the local network. Where fully effective competition exists, monitoring is extraneous because the risk of losing customers provides the necessary incentives for service providers to maintain high operating standards. To the extent that a firm fails to sustain quality service, its customers can obtain better service from alternative sources.

[67] Id. at para. 29.

MCI believes, however, that the Commission should restrict its monitoring solely to traditional wireline telephone service and basic access. This is because either there are alternative regulations that provide monitoring for other services (and FCC oversight would be redundant), or because the services are subject to competition, and therefore, rely upon the market to ensure adequate service quality. For example, the 1984 Cable Act governs the services that LECs might offer over coaxial cable. Also, Personal Communications Services ("PCS") will be subject to competition and will not require specific monitoring. Expanding monitoring to include services such as these would serve only to squander scarce Commission resources and increase the cost of service for the LECs and their ratepayers. MCI recommends no modifications to the Commission's service and infrastructure reporting requirements at this time.

BASELINE ISSUE 8: RATES AND REGULATIONS FOR NEW SERVICES

Baseline Issue 8a: Whether the LEC price cap new services requirements impose unnecessary regulatory impediments to the development and introduction of new services, with specific identification of what those impediments are and an assessment of their magnitude.

Although the Commission initially adopted a net revenue test[38] for LEC new services under price caps, on reconsideration the Commission imposed a ceiling on LEC new service rates. It subsequently revised the new services test again in

[38] The net revenue test requires the company to demonstrate that the change in revenues that occurs after the introduction of the new service exceeds the change in cost. The change in revenue is the increase in revenues from the new service less any revenue lost when customers switch from existing services.

the Part 69 ONA Order to provide a flexible approach to pricing new services that in theory was intended to give LECs incentives to introduce new services.[89] MCI supports retention of an upper limit on new service prices because the LECs continue to have extensive market power that enables them to abuse the flexibility provided by a net revenue test like the one that applies to AT&T.

If LECs are given unfettered flexibility to set new service prices at any level regardless of cost, they will gain additional and unwarranted flexibility when the new services are brought within the price cap. This is illustrated by the following numerical example: Assume a LEC offers a single existing service under the price cap, that service costs $1.00, and is priced at $1.00. The LEC then introduces a new service that costs $0.50, but prices it at $1.00. Assume further that during the base period when this new service is introduced, the LEC sells the same number of units of the existing service and the new service. When the new service is rolled into the price cap, the average price will be $1.00. However, the average cost will now be ($1.00 + $0.50) / 2, or $0.75. Thus, the LEC is pricing its body of services at $0.25 above its costs.

There are two issues raised by this example. First, price cap regulation was grounded on the assertion that initial price cap rates were reasonable relative to the rate of return system then in effect.[90] The logic of initializing new service rates

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[89] Part 69 ONA Order, 6 FCC Rcd at 4524 (1991), recon., 7 FCC Rcd at 5235 (1992).

[90] LEC Price Cap Order, 5 FCC Rcd at 6814.

similarly requires that the rates bear some reasonable relationship to cost. Second, if new services rates are incorporated into price caps at a level in excess of costs, LECs can easily raise other rates in a category or basket. While price cap regulation permits offsetting price changes, the extra measure of flexibility afforded to LECs in this example demonstrates how they can gain additional pricing flexibility not contemplated in the carefully calibrated system of baskets, categories, and pricing bands.

The Commission's current new services cost support rules set both a floor and a ceiling for a new service. The floor -- direct costs -- ensures that the new services are not being subsidized by existing services. It also guards against the possibility of LEC predatory pricing.[91] Without these protections, the LECs would be able to leverage their monopoly position to the detriment of captive ratepayers.

[91] The Commission allows an alternative test to demonstrate that the price of a new service is not too high. If a new service is a close substitute for an existing service, the LECs may demonstrate that the rate for a new service is reasonable by showing that the rate does not exceed the rate for the existing service. Part 69 ONA Order, 6 FCC Rcd 4524 (1991), recon., 7 FCC Rcd 5235 (1992).

<u>Baseline Issue 9b</u>: Whether, and how, the Commission should modify the LEC price cap new services procedures and cost support rules to ensure that these rules advance our goals of encouraging innovation and setting reasonable rates.

While the structure of the current new service rules provides necessary lower and upper pricing limits (and should be maintained), the Commission should more clearly define the underlying concepts. Specifically, the terms "direct cost" and "reasonable overhead" need to be refined.

The direct costs of services should be explicitly defined as total service long run incremental costs ("TS-LRIC") because this measure represents the economically relevant cost, i.e., the costs competitive firms would consider in pricing their services. Reasonable overheads should be based on the ratio of total costs to direct costs that are obtainable from an easily verified publicly available source.[92] This method of setting ceilings for new services rates will give the companies adequate incentive to introduce new services, while reducing the administrative burden of reviewing the cost studies necessary to support overhead calculations derived using another methodology.

The Commission should maintain the same cost showing for all new price cap services, regardless of the level of competition they face. LECs do not offer

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[92] The Commission adopted this method of computing overheads in the ONA Order. ONA Order, 9 FCC Rcd at 458. Overhead costs are computed by applying a ratio of embedded total cost to embedded direct cost.

While incremental costs are routinely available for direct costs in the interstate jurisdiction, there is no source of LRIC for LECs' total costs. In the absence of a LRIC study of total costs, MCI prefers to rely on the next best source of cost data -- ARMIS.

any services that are sufficiently competitive to justify any reduced cost support requirement at this time. The LECs, however, have a strong incentive to set rates for new interconnection services -- those that they sell to their dependent competitors -- at a level above their costs. Thus, the Commission should continue to require new services to meet the same cost showing that applies to existing interconnection services, and to exclude these from price cap regulation for the present.

Nor does MCI support the proposal that new services should receive less scrutiny when first introduced, with increased scrutiny when they are rolled into the price cap indexes. This would give the LECs too much initial flexibility and increase the administrative costs of reviewing the services. In any case, the short period in which actual experience with the demand for new services could be gathered before they were moved into price caps would not provide information that was superior to the original forecast.

Baseline Issue 8c: Whether new services are available on an equal basis to all LEC customers. Whether the Commission should revise the LEC price cap plan to ensure the universal availability of new services. How widely LECs have made new services available to customers.

MCI is aware of no problem concerning the general availability of new services, since the Commission has mandated the new capabilities LECs have introduced during the review period.

BASELINE ISSUE 9: EQUALIZATION OF REGULATIONS FOR LECS AND CAPS

Baseline Issue 9a: Whether the Commission's current rules for computing AT&T's exogenous access costs should be revised to equalize the treatment of LEC and CAP access rates in the calculation of AT&T's exogenous access costs.

In its initial AT&T Price Cap Order, the Commission did not require AT&T to change its price cap index to reflect decreases in underlying access costs realized by use of competitive access providers' ("CAPs") networks. It argued that it did not want to remove the incentive for AT&T to minimize its access costs.[93] If AT&T were to obtain access services from CAPs, the LECs would gain the incentive to reduce their access prices. In the instant Notice, the Commission recognizes that its new expanded interconnection policy for switched access services will increase competition for switched access. Since AT&T is not required to treat CAP access price changes similarly to LEC price changes, AT&T may opt for CAP access services in lieu of LEC access services.[94]

The Commission has offered three reasons for requiring AT&T to treat LEC access cost changes as exogenous: (1) the changes result from the Commission's regulatory process (and thus are outside AT&T's control); (2) access charges represent a significant portion of AT&T's costs; and (3) such charges are unique

[93] AT&T Price Cap Order, 5 FCC Rcd at 3020-21.

[94] Notice, at para. 36. This bias will occur because reductions in AT&T's access costs due to rate cuts by LECs result in a reduction in AT&T's price cap index, while rate cuts by CAPs would not be flowed through to AT&T's price cap index.

to telecommunications companies.[95] For these reasons, the Commission concluded that access charge changes were unlikely to be reflected in the GNP-PI.

MCI believes that it is appropriate to allow AT&T to benefit from the efficiency gains associated with selecting a lower cost provider of access. Not only does this give the LECs an incentive to lower their access charges, but it also encourages alternative access vendors to offer competitive services.

When AT&T switches vendors, it should not be required to flow through the impact of this change to its price cap index. Once AT&T has selected a new access provider, however, the changes in that access providers' rates are generally outside AT&T's control and should be accorded exogenous treatment.[96] Thus, MCI recommends that the Commission require exogenous treatment by AT&T for changes in both LEC and CAP rates, but not the access cost reduction AT&T realizes by switching between LECs and CAPs. The benefit of this approach is that it rewards AT&T for achieving efficiencies over which it does have control, while encouraging the development of competition that ultimately will incite LECs to lower their rates.[97]

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[95] AT&T Price Cap Order, 4 FCC Rcd at 3005.

[96] It may be administratively difficult to verify changes in CAP rates because the CAPs file only ranges of rates in their tariffs. Exogenous treatment of CAP access charge changes, therefore, would require additional administrative oversight by the Commission.

[97] The Commission reviewed the AT&T price cap plan in 1993, and concluded without modification to exogenous cost theory or practice. Since a broad review of exogenous costs as applied to AT&T is beyond the scope of this proceeding should be to reconcile its treatment of LEC access charge changes with CAP access charge changes.

Baseline Issue 9b: Whether any other rules or policies that relate to LEC price cap regulations should be revised to equalize Commission treatment of LECs and CAPs, and if so, what the revised rules and policies should be.

MCI sees no need to make any other changes to equalize the treatment of LECs and CAPs at this time. LECs are, and will continue to be, the dominant exchange carriers in their geographic areas for the foreseeable future.

BASELINE ISSUE 10: SALES AND SWAPS OF EXCHANGES

Whether, and how, the process for granting waivers of the price cap rules governing mergers and acquisitions or the price cap rules themselves should be revised so as to prevent unreasonable cost shifting and maintain the efficiency incentives of the LEC price cap plan.

Under current Commission rules, when price cap companies sell exchanges, if the purchasing companies are not already price cap carriers, they must convert to that status. At its discretion, however, the Commission may grant waivers to allow purchasing LECs to remain under rate of return regulation. MCI urges the Commission to adopt a waiver standard that guarantees that these exchanges of properties do not result in unjustified increases in interstate access rates.

In some instances, sound public interest reasons can support sales of exchanges from price cap regulated LECs to a rate of return LECs. For instance, acquiring carriers may be able to run the exchanges at lower cost than the price cap LECs. Similarly, economies of scale could result from combining adjacent properties. Or, it simply may benefit the public for a single LEC to provide service to a discrete community of interest. The waiver process should not discourage these types of transfers.

The waiver process, however, must guard against LECs engaging in exchange transactions that are driven by financial motives that benefit the LECs at the expense of their interstate access customers. These transactions generally provide no benefits at all to end users. By selling a high cost exchange, the price cap LECs will lower their total costs. Since their initial price cap rates were set based on the costs that include the sold exchanges, however, the LECs will achieve apparent productivity gains (e.g., lower overall costs) simply because they divested themselves of higher cost properties.[88]

While the selling LECs' profits increase at the expense of their access customers, these customers may be forced to pay higher rates for the same access services the transferred exchanges provide. That is, the acquiring companies may qualify for triple-DEM weighting or for increased USF payments because of the cost characteristics of the properties. In either case, the IXCs' interstate costs increase solely as a result of the change in ownership of the LEC property, even though the service essentially remains the same.[89]

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[88] In the unlikely event that LECs would sell lower cost exchanges, these concerns would not apply.

[89] The interim USF freeze may mitigate this problem in the short run. However, it is not clear how the overall USF problem eventually will be resolved. Amendment of Part 36 of The Commission's Rules and Establishment of a Joint Board, CC Docket No. 80-286, Report and Order, 9 FCC Rcd 303 (1993).

Because there is no incentive or requirement for purchasing LECs to use funds generated from the DEM and USF subsidies to upgrade the exchanges' plant, they effectively receive windfall profits for which they may be willing to pay a premium. The profits that the price cap carriers make on the sales, however, will not be reflected in lower rates to ratepayers.[100] MCI urges the Commission to adopt a waiver standard that protects interstate ratepayers from these inequitable rate increases.

For the Commission to grant a waiver of its "all-or-nothing" merger and acquisition rule, it should require LECs either to demonstrate that there will be no effect on interstate access rates as a result of the sales, or to take exogenous adjustments to offset the increases.[101] MCI suggests that the exogenous cost offsets should equal the additional subsidies the purchasing carriers receive from the triple-DEM weighting and increased USF payments. In addition, the price cap LECs would reduce their price cap indexes for the changes in their costs due to the sales of the high cost exchanges.

It is necessary to require such an offset because the LECs' productivity factor was set based on the industry's past performance. During this period, LECs

[100] This will not occur even if the LECs' earnings level require them to share their high earnings. Any gains associated with the sales of exchanges is recorded in Account 7350, which is not allocated to the interstate jurisdiction. Thus, any profits from the sales would not be reflected in the LECs' interstate rates of return.

[101] Exogenous treatment of this cost difference qualifies under MCI's proposed standard, because both the acquiring and selling carriers experience changes in their interstate rate bases.

rarely sold exchanges, so the productivity factor did not recognize efficiency gains realized simply by removing high cost properties from the revenue requirement. Thus, this method of achieving productivity gains alters the LECs' interstate revenue requirements, and thereby requires exogenous treatment.

BASELINE ISSUE 11: OTHER REVISIONS TO THE CURRENT LEC PRICE CAP PLAN

Whether the Commission should adopt revisions to the baseline LEC price cap plan in areas other than those specifically discussed in this Notice.

MCI has no further recommendations to make at this time.

BASELINE ISSUE 12: RELATIONSHIP TO OTHER PROCEEDINGS

How the Commission should coordinate the LEC price cap review and any changes in the LEC price cap plan with other proceedings and proposals.

Because the price cap plan serves as a tariff review mechanism, it should be able to accommodate any tariff structure the Commission adopts. Among other pending proceedings that might affect tariff structure, the Commission identifies Ameritech's proposed regulatory model, Rochester's "Open Market" Plan, and both NARUC's and USTA's petitions for access reform.[102] Although resolution of any one of these proceedings could have an enormous impact on the current price cap plan, MCI does not support incorporating any of the potential outcomes of these matters into the instant proceeding. There is too much

[102] Notice, at para. 91.

uncertainty associated with when, if, or how these issues will be resolved. Thus, it is inappropriate to analyze a regulatory plan that will be in effect during the next four years[103] on the basis of indeterminable resolutions of diverse and sometimes incompatible proposals for access charge revisions.

The changes these proceedings could generate may be similar to the types of revisions to the basket composition necessitated by the outcome of the Transport Rate Structure proceeding.[104] The Commission should deal with the results of any other proceedings in a similar manner. To the extent that any Commission proceeding produces minor adjustments to price cap baskets, such revisions should be determined as a separate phase of the relevant docket, as the Commission did when in created the trunking basket in the wake of changes into switched transport. If changes are so significant that they affect the underlying structure of the access charges themselves, it may be appropriate to initiate a separate proceeding at that time to evaluate what changes should be made to the price cap plan.

Simply put, the Commission cannot fashion price cap rules to accommodate yet-undecided outcomes of other proceedings. Instead, it must review price caps in light of the current regulatory environment because it is impossible to second-guess the outcomes of unresolved proceedings in any meaningful way.

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[103] MCI recommends beginning the review of the LEC price cap plan again after three more years of operation, and completing that review in the fourth year.

[104] Trunking Basket Order, 9 FCC Rcd at 615 (1994).

The nature and extent of any changes to price caps that result from decisions in these matters will dictate whether and how the Commission will proceed with price cap evaluation at the appropriate time.

TRANSITION ISSUE 1: CRITERIA FOR REDUCED OR STREAMLINED REGULATION OF PRICE CAP LECS

Transition Issue 1a: The current state of competition for local exchange and interstate access.

Contrary to the claims of the LECs that they face robust competition in many of their markets today, MCI's experience in purchasing access demonstrates the LECs remain de facto monopolists. So long as LECs retain control over bottleneck facilities, the Commission must guard against LEC anti-competitive behavior -- or risk discouraging the development of any effective competition.

Although recent events may give the perception of competition -- e.g., FCC-mandated interconnection and collocation, market tests for delivery of telecommunications services over cable television ("CATV") facilities, and even announcements of MCI forays into the local market -- the economic repercussions of these events will not be realized for a long time. Even if all the competing networks that have been announced to date were built and the necessary tests completed, LECs would likely be able to leverage their historical monopoly power and continue to dominate the markets they serve -- certainly for at least the time period during which the modifications to the price cap plan contemplated by this notice will be in effect.

The reality of today's market is that competitive access providers deliver less than 1% of the access services IXCs purchase.[105] The Commission did not adopt streamlined regulation for AT&T's most competitive services until its overall market share had declined by nearly 40%. In contemplating if it is appropriate to lessen LEC regulatory burdens, it is important to reconcile increased flexibility with the Commission's treatment of AT&T.

Nor do competing technologies offer viable competition.[106] The cost and quality of existing cellular technology preclude it from serving as a practical substitute for land-line telephone service.[107] The feasibility of PCS as a competitive alternative is uncertain because of capacity restrictions, spectrum limitations, and regulatory delay. Tests of the provision of telephone service over cable television facilities have just begun. Existing cable systems would require significant levels of investment before they could offer traditional telecommunications services.[108]

Decades of ratepayer-financed network deployment have created ubiquitous LEC access networks. The investment necessary to offer competitive services in even the major metropolitan areas is staggering. Further, the investment needed

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[105] The Enduring Local Bottleneck, p. 2.

[106] Id.

[107] Cellular systems require an investment of $2,860 per subscriber. Id. at p. 89.

[108] Cable companies would need to invest $835 per subscriber to provide telephone service. Id.

to "catch up" with today's LEC presence does not even consider the over $100 billion in depreciation charges that the LEC industry will generate before the end of the century.[109]

The mere expectation of competition does not provide the appropriate safeguards against the types of anti-competitive behaviors in which the price cap LECs have the opportunity to engage. The LECs may argue that "market contestability" should be used as the standard for assessing the dynamic properties of their markets and extent of their market power. This simply is not the case. The contestable market theory assumes that entrance into the market by competitors is relatively low-cost.[110] In reality, there are significant and sizeable economic barriers to efforts by prospective competitors to enter the local exchange market.[111] Also, the ubiquitous connectivity the LECs enjoy by virtue of their historical monopoly provides them with "decisive control over bottleneck exchange facilities essential for any competing access or dial tone entrant."[112] It is more likely that the threat of competition will cause the LECs to "dig in their

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[109] Id. at p. 3.

[110] W. Baumol, J. Panzar, and R. Willing, Contestable Markets and the Theory of Industry Structure, Harcourt Brace Jovanovich, San Diego, 1988, Chapter 10.

[111] See, Willing/Bernheim Affidavit, "Appropriate Preconditions for Removal of the Interlata Restrictions on the RBOCs," attached to AT&T's Opposition to Ameritech's Motions for "Permanent" and "Temporary" Waivers from the Inter-exchange Restriction of the Decree, February 15, 1994.

[112] The Enduring Local Bottleneck, p. 39.

heels" to hold onto the power that they fear losing, rather than respond as would businesses facing real competition.

<u>Transition Issue 1b</u>: The criteria that should be used for determining when reduced or streamlined regulation for price cap LECs should take effect.

The Commission should perform a multi-factor market analysis to evaluate whether effective competition exists on a service-specific and geographic-specific basis. In performing this analysis, the Commission should recognize that LECs have both the ability and incentive to stifle competition. Thus, if results of such a study are ambiguous, the Commission should err on the side of caution and continue the level of regulation in effect.

MCI comments briefly on the nine categories of factors that the Commission listed as those that should be considered in establishing whether competition exits: